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CONSULTATION CONCERNING THE OECD PRINCIPLES OF CORPORATE GOVERNANCE – DRAFT FOR PUBLIC COMMENT

About the Commission:

The Deutscher Corporate Governance Kodex (German Corporate Governance Code) presents essential statutory regulations for the management and supervision of German listed companies and contains, in the form of recommendations and suggestions, internationally and nationally acknowledged standards for good and responsible corporate governance. Through the declaration of conformity pursuant to § 161 Aktiengesetz (Stock Corporation Act), the code receives legal recognition. Accordingly, the recommendations and suggestions are not mandatory. However, deviations from the recommendations – not the suggestions – have to be explained and disclosed with the annual declaration of conformity (Comply or Explain). The Regierungskommission Deutscher Corporate Governance Kodex, the Commission, formulates these recommendations and suggestions and will review the code at least once a year in order to find out if it still describes the best practice of good corporate governance or if it should be adapted. The members of the Commission are appointed by the German Federal Minister of Justice and for Consumer Protection based on proposals of the Commission.

Comments:

The Commission would like to focus its position on the revised OECD Principles of Corporate Governance (in the following “the Principles”) to four topics of main concern:

1. DUALISTIC, MONISTIC, MIXED SYSTEMS

The Commission understands the need to keep the Principles short. However, considering the sometimes important differences between the roles and responsibilities of boards in dualistic, monistic or mixed systems, the Commission respectfully suggests to be clearer where mentioning only “the board” to underline the differences. The statement in no. 101 may serve as an example: *“Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation.”*

While this statement is certainly true for monistic board structures, it does not entirely correctly reflect the responsibilities of the supervisory board in dualistic systems. The Commission thus calls on the OECD Corporate Governance Committee to review the Principles and its notes carefully to better reflect the differences between dualistic and monistic systems.

There are many aspects where the existence of two separate boards do matter, e.g. when it comes to independence. We would like to indicate that in the dualistic system there is a separation between the supervisory function and the management function. So, the law creates functional independence of the members of the supervisory board from the management board. The supervisory board members are elected by the shareholders (except for the members due to codetermination) as their representatives and they are legally bound to the interests of the company.

2. THE ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

The Principles are very much oriented towards the shareholder value model prioritizing the long-term interest of shareholders against interests of others in the company. Other interests are only additionally mentioned:

“The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context,” p. 30.

For example in Germany the management as well as the supervisory board is legally bound to the interests of the company. This includes interest of stakeholders like employees and creditors. This concept can be called stakeholder model. The Commission would like to respectfully indicate that the Principles do not quite take such approach into account as such. The approach, though, which is also recognized by the Principles, is e.g. a basic instrument against abusive related party transactions:

No. 39 “In addition to disclosure, a key to protecting minority shareholders is a clearly articulated duty of loyalty by board members to the company and to all shareholders,” p.13.

The Commission would propose the Principles to explain the different concepts already in the first section “ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK”.

3. THE ROLE OF INDEPENDENCE

The Commission supports the important role that the Principles place on the concept of independence, which is mentioned quite a few times throughout the document. The Commission proposes to be more precise as to the scope of independence is referred to in each context, also mentioning who or what a person or body should be independent from.

For example in no. 11: *“Supervisory, regulatory and enforcement responsibilities should be vested with bodies that are operationally independent and accountable in the exercise of their functions and powers (...)”, p. 5, it is advisable to indicate that the required independence means independence from the legislator or from politics.*

Another example is no. 22:

“To elect the members of the board is a basic shareholder right. (...) It is increasingly regarded as good practice in many countries for independent board members to have a key role on this committee. To further improve the selection process, the Principles also call for full and timely disclosure of the experience and background of candidates for the board and the nomination process, which will allow an informed assessment of the abilities and suitability of each candidate. It is increasingly considered good practice to also disclose information about any other board positions that nominees hold or for which they have been nominated.”

Another critical observation of the Commission concerns the accumulation of responsibilities on independent board members. Consider the list in no. 125 that states: *“In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisitions and the audit function”, p.35 or Principle E.1. “Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.”* The Principles state that e.g. the independence prerequisites do *“not prevent shareholders from being board members.”* This is true, but as more and more important decisions are passed on to independent board members the role of non-independent directors is undermined. The Commission warns against reserving the most critical supervisory functions for independent members, thus signaling distrust towards non-independent board members.

In the opinion of the Commission it would be advisable to place more emphasis on the reasons of independence or non-independence. This is to say that a specific situation resulting in a conflict of interest for certain board members may render them non-independent in this situation, while leaving the independence intact and unquestioned in other situations. On the one hand for concrete conflicts of interest there are procedural arrangements in place probably in most jurisdictions so that concrete conflicts of interest concerning board decisions are dealt with, e.g. by abstaining from vote or even not taking part in the discussions. This is in the due interest of the boards so that decisions cannot be “infected” by conflicts of interest. On the other hand the catalogue of independence is often quite rigid and therefore there should be the possibility of the supervisory board to decide on committee membership on a case by case basis taking into account possible conflicts of interests with regard to the respective committee. The Commission thus respectfully submits to at least include a qualification to this effect, if not reviewing the list of responsibilities reserved for independent board members.

4. SHAREHOLDER VOTES

There is a generally welcomed trend to grant shareholders more rights. The EU Commission for example, aims to foster long term engagement of shareholders by giving them a “say on pay”. The Commission would like to emphasize that

the distribution of powers in a company stems from each country's legal system. In the German dualistic system a sensitive system of "checks and balances" exists. Therefore, the Commission welcomes statement in no. 14 that:

"As a practical matter, however, the corporation cannot be managed by shareholder referendum. The shareholding body is made up of individuals and institutions whose interests, goals, investment horizons and capabilities vary. Moreover, the corporation's management must be able to take business decisions rapidly. In light of these realities and the complexity of managing the corporation's affairs in fast moving and ever changing markets, shareholders are not expected to assume responsibility for managing corporate activities. The responsibility for corporate strategy and operations is typically placed in the hands of the board and a management team that is selected, motivated and, when necessary, replaced by the board."

4.1 "SAY ON PAY"

The Principles state: *"4. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known, including through votes at annual shareholder meetings, on the remuneration ~~policy for~~ of board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval,"* p. 9.

The Commission strongly recommends not deleting the words "policy for" as there is a significant difference between a vote on the remuneration policy and a vote on the actual remuneration of management board members in two-tier systems. The latter should always be left to the boards responsible and to contractual agreements. In the opinion of the Commission, the AGM is not the correct forum for detailed decisions like the decision on the actual remuneration. This was originally reflected in no. 23, which deals with the details of "say on pay": *"Although board and executive contracts are not an appropriate subject for approval by the general meeting of shareholders, there should be a means by which they can express their views."* Unfortunately, this sentence has been deleted in the current draft. What is striking is that the details provision of no. 23 reveals no preference for having a say on the remuneration policy or on the remuneration itself. This seems to be in contradiction with the statement in no. 4 cited above.

The Commission calls on the OECD Corporate Governance Committee not to interfere with the choice of individual countries' legal systems about the balance of power between the management, board and shareholders regarding remuneration issues. This is especially true for dualistic systems as in Germany where the supervisory board, being a separate body from the management board, decides on the remuneration of the latter. In this way, the inherent problem of monistic systems, in which the board decides on its own remuneration, does not arise in dualistic systems, rendering the necessity of further safeguards, e.g. by establishing a binding say on pay, obsolete.

For the remuneration of the supervisory board members in Germany the AGM traditionally effects a binding vote. Probably in by far the most companies the remuneration for supervisory board members is even part of the statutes. This is due to the special checks and balances in the dualistic system, in order to avoid that the supervisory board determines the remuneration for itself. There is a trend to only grant fixed remuneration to the supervisory board members, so the remuneration system is traditionally not very complicated. Also, there is no contractual relationship with supervisory board members and the company. Therefore a binding shareholder vote for the remuneration of the

supervisory board is already long time practice in Germany. The supervisory board has to negotiate contracts with the management board members which includes remuneration. The members of the supervisory board are personally liable if that decision is unreasonable (unangemessen). In so far a binding vote of the AGM would undermine the competence of the supervisory board. That is why a binding vote leads to legal problems in the dualistic system and interferes with its checks and balances. The German experience also shows that a non legally binding vote on the remuneration system of members of the management board has normally the desired effect that the supervisory board rethinks the system by considering the opinions of shareholders.

In respect to the members of the management board shareholders in Germany can vote on the remuneration principles and policies, but the vote is not and should not be binding.

4.2. RELATED PARTY TRANSACTIONS (RPTs)

The Commission expressly welcomes the approach of the Principles towards Related Party Transactions and urges the OECD Corporate Governance Committee to not be influenced by the current proposal of the EU Commission on RPT contained in the EU Commission's draft directive on shareholders' rights. The EU Commission's proposal foresees a binding ex ante shareholder vote even for transactions in the normal course of business as long as a related party is involved. In addition to transactions above a certain threshold, any transaction which "can" have significant influence on turnover and return has to be put to shareholder vote. It is obvious that such transactions are common, especially in corporate groups. Therefore, the Commission expects a lot of RPT on the AGMs, as the proposed provision is extremely broad. The Commission would like to come back to the Principles statement in no. 14 "*the corporation cannot be managed by shareholder referendum*" and fears that exactly that is put into question by the new provision.

The Principles are more open to other solutions that company law systems may have elaborated. "*F. Related-party transactions should be approved and conducted in a manner that ensures proper management of conflict of interest and protects the interest of the company and its shareholders / 1. Conflicts of interest inherent in related-party transactions should be addressed / 34. The potential abuse of related party transactions is an important policy issue in all markets, but particularly in those where corporate ownership is concentrated and corporate groups prevail. Banning these transactions is normally not a solution as there is nothing wrong per se with entering into transactions with related parties, provided that the conflicts of interest inherent in those transactions are adequately addressed, including through proper monitoring and disclosure. This is all the more important where significant portions of income and/or costs arise from transactions with related parties.*"

The Commission agrees with the latter analysis and would like to emphasize that in such a market with traditionally concentrated corporate ownership and prevailing corporate groups like Germany an elaborate group law regime has evolved dealing with inherent conflicts of interests. The group law sets the framework to lawfully exercise controlling ownership. The scope of the regime is even wider and not only deals with any 'transaction' (without a threshold) but with any means of influencing the subsidiary's management. The management and supervisory board are responsible to comply with that set of rules in the first place. So, the solution in Germany is not an approval of the AGM, except for example when entering into a group based on a contractual relationship (Vertragskonzern) or any transaction or

measure whose effect would be the same as a change of the company's statutes. The latter is a general rule developed by the jurisdiction and is not restricted to transactions with related parties.

The Principles further describe: *"Shareholders may also be given a say in approving certain transactions, with interested shareholders excluded."* The Commission is concerned with the trend to demand such a shareholder vote in all jurisdictions no matter how strongly this would interfere with the checks and balances in such jurisdiction. Therefore, the Commission welcomes that the OECD does not follow that call. The Commission agrees with the statement of the Principles that *"with the common aim of improving market credibility, the choice and ultimate design of different provisions to protect minority shareholders necessarily depends on the overall regulatory framework and the national legal system."*

5. ELIMINATION OF IMPEDIMENTS TO CROSS BORDER VOTING

The Commission agrees with the Principles that eliminating impediments to cross border voting is essential for effective voting rights. However, the OECD Principles remain a little opaque in this respect.

In no. 46 it is stated that *"A complementary approach to participation in shareholders' meetings is to establish a continuing dialogue with portfolio companies. Such a dialogue between institutional investors and companies should be encouraged, especially by lifting unnecessary regulatory barriers."*¹ The Commission believes that shareholders should have the possibility to have their identity transferred to companies via the intermediary chain in order to actually be able to hold the required dialogue. . To this end, no. 79 remains somewhat weak: *"Particularly for enforcement purposes, and to identify potential conflicts of interest, related party transactions and insider trading, information about record ownership needs to be complemented with updated information about beneficial ownership. In cases where major shareholdings are held through intermediary structures or arrangements, information about the beneficial owners should therefore be obtainable at least by regulatory and enforcement agencies and/or through the judicial process and as much as possible be disclosed."*

The Commission respectfully submits that cross border voting and information chains have to be effective in order to allow shareholders to effect their votes easily and companies to enter into dialogue with their owners. In the Commission's view, this should be stated more clearly.

¹ If the Principles promote the dialogue with investors it is important to stress the equal treatment of shareholders. It is important that the Principles state that „Such a dialogue between institutional investors and companies should be encouraged, especially by lifting unnecessary regulatory barriers, although it is incumbent on the company to treat all investors equally and not to divulge information to the institutional investors which is not at the same time made available to the market.“